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No. 59

In the Supreme Court of the United States

OCTOBER TERM, 1928

MABEL G. REINECKE, COLLECTOR OF INTERNAL REVENUE FOR THE FIRST DISTRICT OF ILLINOIS, PETITIONER

v.

EUDORA HULL SPALDING

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

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No. —

MABEL G. REINECKE, COLLECTOR OF INTERNAL REVENUE for the First District of Illinois, petitioner

v.

EUDORA HULL SPALDING

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

PETITION

The Attorney General on behalf of Mabel G. Reinecke, Collector of Internal Revenue for the First District of Illinois, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Seventh Circuit entered in the above case on January 2, 1929, affirming the judgment of the District Court of the United States for the Northern District of Illinois.

QUESTION PRESENTED

The question in this case is whether a taxpayer may compute the allowances which the statute per-

mits for depletion of interests in mines in a manner not provided for in the regulations made pursuant to statutory authority, substituting in place thereof the value in the ground of the specific ore extracted during the year for which the computation is made, disregarding wholly the March 1, 1913, value of the taxpayer's interests in the mines and the relation between that value and the total reserves.

STATUTES AND REGULATIONS INVOLVED

This action being brought to recover taxes for two years, the provisions of two Acts are involved. Taxes for the year 1917 are to be computed under the Revenue Act of 1917 (c. 63, 40 Stat. 300) and the Revenue Act of 1916 (c. 463, 39 Stat. 756), and specifically under Section 5 (a) (c. 463, 39 Stat. 756, 759), which reads, so far as material, as follows:

> That in computing net income in the case of a citizen or resident of the United States—
>
> (a) For the purpose of the tax there shall be allowed as deductions—
>
> * * * * *
>
> Eighth. (a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return

and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided,* That when the allowances authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made. No deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate, and no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made.

Taxes for the year 1918 (c. 18, 40 Stat. 1057, 1067) are controlled by the Revenue Act of 1918, which provides in part as follows:

> SEC. 214. (a) That in computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein)

on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee.

Complying with the provisions of the statutes the following regulations were made:

Article 210 of Regulations 45 (1920 ed.) provides in part as follows:

(b) When the value of the property at the basic date has been determined, depletion for the taxable year shall be determined by dividing the value remaining for depletion by the number of units of mineral to which this value is applicable, and by multiplying the unit value for depletion, so determined, by the number of units sold within the taxable year. In the selection of a unit for depletion preference shall be given to the principal or customary unit or units paid for in the product sold.

Article 172 of Regulations 33 (Revised) provides in part as follows:

> PAR. 532. The *en bloc* value having been thus ascertained, an estimate of the number of units (tons, pounds, etc.) should be made. The *en bloc* value divided by the estimated number of units in the property will determine the per unit value, or amount of capital applicable to each unit, which, multiplied by the number of units mined and sold during any one year, will determine the sum which will constitute an allowable deduction from the gross income of that year on account of depletion.

STATEMENT

The taxpayer is the owner of an undivided one-sixth interest in certain lands underlaid with iron ore, which prior to March 1, 1913, she and her co-owners had leased to various lessees for the purpose of extracting or mining, taking out, and removing and shipping therefrom the merchantable ore upon a royalty at the rate of twenty-five cents per ton. (R. 90, 106, 116, 127, 138, 149, 160.) During the year 1917 the taxpayer received in royalties the sum of $260,072.30. (R. 29.) In her income-tax return for that year she reported the amount so received as income and deducted as a reasonable allowance for depletion the same amount (Plaintiff's Exhibit A, R. 61), thus reporting as taxable income from rents and royalties "none." During the year 1918 she received royalties in the sum of $219,940.43. (R. 29.) In her income-tax return for that year she

reported the amount so received as income and deducted as a reasonable allowance for depletion the same amount (Plaintiff's Exhibit B, R. 77), thus reporting as taxable income from rents and royalties "none." Upon the filing of these returns the Commissioner notified the taxpayer (R. 176):

> Your method of deducting from gross income the entire amount received as royalty from iron mines as depletion is not approved by this office. The correct amount to be deducted for depletion, based upon the unit cost per ton of mineral reserves, as of March 1, 1913, as determined by the Valuation Engineers of this Department is shown as follows: * * *
>
> For 1917 ..... $92,194.92 (R. 176),
> and for 1918 ..... 77,968.20 (R. 195) * * *.

Later, upon reconsideration, the Commissioner increased the depletion for 1917 to $99,561.20 (R. 192), for 1918 to $84,979.55 (R. 198).

The taxpayer paid under protest the additional tax assessed by reason of the changes made in the depletion allowances and filed claims for refund. Her claim for the year 1917 alleges that the additional tax is erroneous because—

> Tax as assessed is based upon income received from royalties from iron ore mines. Depletion amounting to $99,561.20 was allowed to taxpayer, whereas depletion amounting to $203,510.86 should be allowed. The latter amount is the present worth of the ore mined in 1917, as of March 1, 1913,

and is arrived at by discounting the amount received in 1917 at 5% to March 1, 1913. (R. 201.)

The claim for 1918 was predicated upon the same alleged error. (R. 204.) Both of these claims were rejected (R. 206, 207), whereupon the taxpayer brought this action in the United States District Court for the Northern District of Illinois.

The Government contended in the courts below (R. 23, 214) that the proper allowance for depletion in each year in respect to each mine must, in accordance with the regulations, be determined by multiplying the March 1, 1913, value of the taxpayer's interest in that mine by the percentage of the whole reserve which was withdrawn and paid for during the year for which the allowance is being computed, and that, therefore, the proper allowance could not be computed unless the March 1, 1913, value of the taxpayer's interest in the mine and the reserve tonnage were shown; that the taxpayer having failed to show these factors could not recover.

The taxpayer contended and the Circuit Court of Appeals held (R. 223) that the proper allowance for depletion was determined, not by the March 1, 1913, value of the taxpayer's interest and the relation between the reserves and the amount withdrawn, but by "the market value in the mine of the product mined and sold during the year for which the return is made"; that the Commissioner's val-

uation was erroneous in that it did not establish this market value; and that, since the plaintiff had established this market value she was entitled to the deduction claimed by her.

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that the taxpayer was entitled under Section 214 (a) (10) of the Revenue Act of 1918 and under Section 5 (a) Eighth of the Revenue Act of 1916 to compute the reasonable allowance for depletion upon the basis of the fair cash market value in the mine of the tonnage mined during the taxable year, and to deduct this value less the "interest-carrying charge," said to be five per cent per annum from March 1, 1913, to 1916. (R. 226.) This is erroneous because the amount so allowed is a greater part of the taxpayer's capital investment than the tonnage paid for is of the whole reserve. The proper allowance should be computed by determining the percentage of the whole reserve which was withdrawn and paid for during the taxable year and taking this same percentage of the plaintiff's capital investment, that is, of the March 1, 1913, value of the plaintiff's interest in the mine. In other words, the depletion in dollars is the same percentage of the capital investment as the depletion in tons is of the whole reserve, whereas the Circuit Court of Appeals has allowed depletion in dollars at a rate which is not the same as the rate of the actual depletion in tons.

REASONS FOR GRANTING THE WRIT

The Circuit Court of Appeals in affirming the judgment of the District Court and in allowing the respondent to take the deductions claimed by her has laid down a rule which is in conflict with the rule established by the Circuit Court of Appeals for the Third Circuit in the case of *New Creek Company* v. *Lederer,* 295 Fed. 433, certiorari denied, 265 U. S. 581, and with the principle announced by this Court in the case of *United States* v. *Ludey,* 274 U. S. 295.

The rule announced by the Circuit Court of Appeals disregards the regulations duly promulgated and which, as is not the case in respect to all regulations, Congress specifically said should govern the method of arriving at a reasonable allowance for depletion.

These regulations have been consistently followed since 1916, not only under the Acts involved in the case at bar but also under all subsequent Acts. They have been almost unanimously accepted by taxpayers as correct.

The rule enables taxpayers to recover in money a large part of the capital before the exhaustion of the ore in which that capital is still invested.

The question is one of general importance. Depletion allowances have been computed by the Bureau in the manner rejected by the Circuit Court of Appeals in this case with absolute consistency since 1916. Any change in the rule at this time

would not only necessitate a recomputation and revision by the Bureau of all returns as to which refunds are not barred, but would also deprive taxpayers who have previously complied with the regulations of the right intended to be given them by statute of recovering their capital investments in full.

Wherefore, it is respectfully submitted that this petition for certiorari to review the judgment of the Circuit Court of Appeals for the Seventh Circuit should be granted.

WILLIAM D. MITCHELL,
Attorney General.
ALFRED A. WHEAT,
Special Assistant to the Attorney General.
MARCH, 1929.

BRIEF IN SUPPORT OF PETITION

OPINIONS BELOW

The District Court did not write an opinion. Its reasons for directing a verdict in favor of the plaintiff are set out on page 56 of the Record. The opinion of the Circuit Court of Appeals (R. 223) has not yet been officially reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on January 2, 1929. (R. 222.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

STATEMENT

A statement of the facts and of the errors relied upon will be found in the petition.

ARGUMENT

The amount to be allowed, if any, on account of the depletion of mines, is discretionary with Congress.

> *Lynch* v. *Alworth-Stephens Company,* 267 U. S. 364; *Stratton's Independence* v. *Howbert,* 231 U. S. 399; *Von Baumbach* v. *Sargent Land Company,* 242 U. S. 503; *Goldfield Consolidated Mines Company* v. *Scott,* 247 U. S. 126; *United States* v. *Biwabik Mining Company,* 247 U. S. 116; *Stanton* v. *Baltic Mining Company,* 240 U. S. 103.

The Revenue Act of 1918 expressly provides that the allowance for depletion shall be "based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date." This Court in the case of *United States* v. *Ludey,* 274 U. S. 295, construing the provisions of the Revenue Act of 1916 held that under that Act also it was intended that the depletion allowance should be based upon the March 1, 1913, value of the plaintiff's interest in the mining property. The Circuit Court of Appeals does not base the allowance for either year upon the March 1, 1913, value of the respondent's interest in the mines, but upon the market value of

the ore mined and sold during the year. The result of calculating the allowance upon the basis adopted by the Circuit Court of Appeals is to defeat the intention of the statute which, as this Court said in the *Ludey Case, supra,* was to deduct the estimated cost of the part of the reserve used up in computing the net income for the year in which the reserve was used up.

The deduction permitted by the Circuit Court of Appeals nullifies the Commissioner's regulations, subdivision (b) of Article 210, Regulations 45; Paragraph 532, Article 172, Regulations 33, which regulations were approved by the Circuit Court of Appeals for the Third Circuit in the case of *New Creek Company* v. *Lederer,* 295 Fed. 433, and by this Court in the *Ludey Case, supra.* Cf. *Appeal of Kehota Mining Company,* 3 B. T. A. 885; *Kehota Mining Company* v. *Lewellyn,* 28 F. (2d) 995, affirmed by the Circuit Court of Appeals for the Third Circuit, not yet officially reported. These regulations are not mere interpretations by the Commissioner of the law. Congress has expressly delegated to the Commissioner the power to prescribe by regulations the method of ascertaining a reasonable allowance. The regulations made in pursuance of this authority are as binding upon the courts as if incorporated into the law by Congress itself.

Boske v. *Comingore,* 177 U. S. 459; *United States* v. *Birdsall,* 233 U. S. 223; *United States* v. *Morehead,* 243 U. S. 607.

The regulations promulgated by the Commissioner are in accordance with the customary practice in the mining industry. (R. 48, et seq.) Their effect is to return the capital invested in step with the exhaustion of the physical property, so that at all times the capital of the taxpayer is intact. The allowance permitted by the Circuit Court of Appeals may result in the return of the taxpayer's entire capital prior to the exhaustion of the mine, or it may result in his never receiving tax free his whole capital investment, but it can not result in his receiving back the last of his capital coincident with the exhaustion of the last of the ore unless by an unusual coincidence the actual rate of extraction should be the same as the extraction estimated for the fixing of the capital value, and in no event can it result in a return of capital in step with actual exhaustion.

In the case of *United States* v. *Ludey, supra,* this Court said (p. 302):

> The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can

> be determined, so the estimated cost of the part of the reserve used up is allowed. The fact that the reserve is hidden from sight presents difficulties in making an estimate of the amount of the deposits. The actual quantity can rarely be measured. It must be approximated. And because the quantity originally in the reserve is not actually known, the percentage of the whole withdrawn in any year, and hence the appropriate depletion charge, is necessarily a rough estimate. But Congress concluded, in the light of experience, that it was better to act upon a rough estimate than to ignore the fact of depletion.

The Government construes this opinion to mean just what it says, namely, that each ton of ore in the mine represents a proportionate part of the taxpayer's capital investment, and that, accordingly, the extraction of one ton of ore "depletes" the taxpayer's capital in the same proportion as it "depletes" the mineral content.

In the case of interests acquired prior to March 1, 1913, the fair market value as of that date of the taxpayer's interest is the taxpayer's capital investment. The witnesses introduced by the respondent on the question of value in this case expressly disclaimed any knowledge of or intention to testify as to this value. (R. 33, 35, 37.) With deference to the statement of the Circuit Court of Appeals that the only question involved in this case is the "method of arriving at the value of the iron ore

in the ground on March 1, 1913" (R. 223), there are many other factors entering into the valuation of the taxpayer's interest in the mines as of March 1, 1913. The determination of this value is a question of fact, and to quote John A. Savage, one of the respondent's witnesses, "It would require a good deal of calculation and certain assumptions as to how fast that ore would be shipped. Then it would require discounting against those assumptions to present value." (R. 33.) If, as the Circuit Court of Appeals seems to hold, the method used by the Commissioner in determining the value as of March 1, 1913, is wrong, this record certainly does not show what is right. The taxpayer in this case has not shown, has not attempted to show, and indeed does not contend, that the amounts acutally allowed by the Commissioner are not the same percentage of the taxpayer's capital investment as the tonnage paid for is of the whole reserve. She complains, and has shown, that she has not been allowed an amount greater than this percentage. She claimed, and has been allowed by the courts, an amount based solely upon the market value of the ore in place regardless of the March 1, 1913, value of her interests in the mines or in each ton of ore, and regardless of the relation between the amount allowed and the capital investment. This value in place is not shown and indeed could not be shown to have the same relation to the capital investment as the tonnage withdrawn has to the total reserve. The

taxpayer has, therefore, not shown in this case either that the amount actually allowed by the Commissioner was erroneous or that the amount she claims is correct. The Circuit Court of Appeals was, therefore, in error in sustaining the action of the lower court in directing a verdict for the respondent and in refusing to direct a verdict for the petitioner.

CONCLUSION

Because of the far-reaching effect of the opinion below and its wide departure from the theory of depletion adopted by the regulations, and sanctioned by this Court, and by the Circuit Court of Appeals for the Third Circuit, and because of the manifest importance of an authoritative determination of the basis upon which depletion allowances must be calculated, it is respectfully submitted that the petition for certiorari in this case should be granted.

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MARCH, 1929.

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